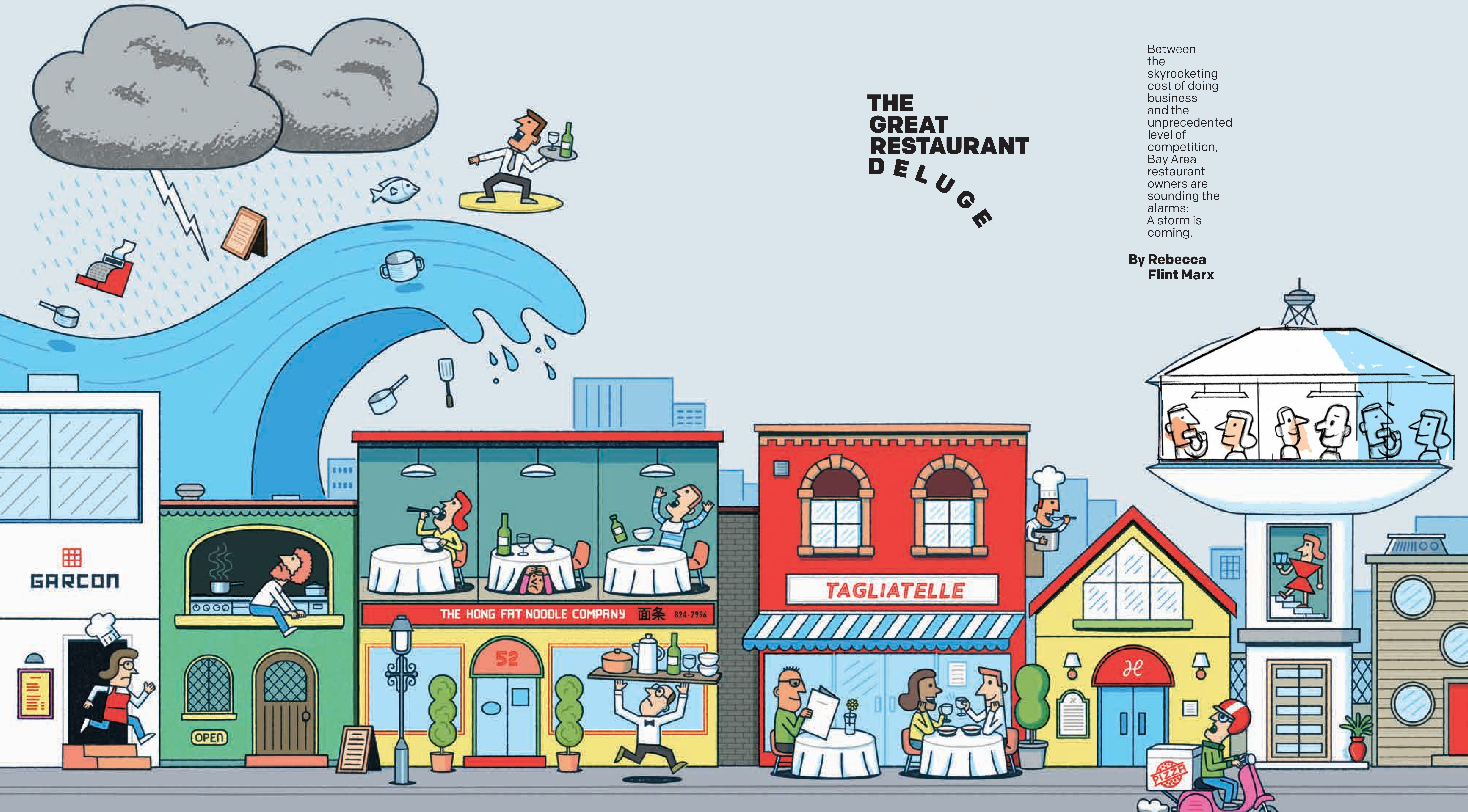
THE GREAT RESTAURANT DELUGE

Between the skyrocketing cost of doing business and the unprecedented level of competition, Bay Area restaurant owners are sounding the alarms: A storm is coming.

By Rebecca Flint Marx



Illustrations by Allan Sanders

WHEN

IT COMES TO OPENING successful restaurants, Kurt Huffman has an impressive track record. Since 2008, when he founded the Portland, Oregon, hospitality company ChefStable, he's rolled out 14 popular and critically acclaimed restaurants throughout the Northwest. So in 2014, when Huffman made the leap to San Francisco to open the Pearl—a 20,200-square-foot restaurant with a rooftop garden and an event space, inside a former boiler-manufacturing facility in the Dogpatch—he thought he was prepared. He had a novel concept and the chops to pull it off; he had a coterie of deep-pocketed investors; and he had a shrewd San Francisco–based business partner in Adam Mendelson, a former renewable-energy deveopment director. In April of that year, the pair signed a lease for what Huffman says is "substantially longer" than 10 years (he won't disclose the rent); three months later they filed a change-of-use permit with the city. And that's when all the fun began.

"From lease signing to opening, we average about ten weeks in Portland," Huffman says. In San Francisco, that wasn't the case: The Pearl's permitting process took over 15 months. "So, step one, plan on it taking five times longer than any other city," he says. "And step two, plan on spending a lot more money in that process than anywhere else."

The Pearl's liquor license cost in excess of $200,000, a price tag that is both astronomical and the norm in San Francisco. Construction costs were likewise a rude awakening: Thanks to the city's building boom, "subcontractors can charge almost double what I pay in Portland," Huffman says. "When I saw our budget for San Francisco, I thought, 'This is impossible. No one charges $20 a square foot for installing tile.' It just didn't make sense to me." All told, the budget swelled 20 percent from its initial projections. "In Portland my mind is always on trying to do something unusual or interesting or challenging, because I'm not petrified of failure," says Huffman, who has been paying rent on the Dogpatch space for roughly two years now. "In San Francisco, because the stakes are so high, I'm petrified of failure."

And building costs are far from his only concern. "I don't know who you hire to be a dishwasher or line cook in San Francisco anymore, because no cook or dishwasher can live here," he says. "In Portland, keeping chefs is by far our biggest challenge. When I superimpose that on the San Francisco market, I feel like, oh my God, how do those guys do it down there?"

It's a question many in the industry are asking themselves these days. Talk to anybody who runs a restaurant and he or she will tell you that what has always been a very tough business has gotten exponentially tougher in the past few years, thanks to a confluence of economic factors. There is, of course, the perpetual struggle to find staff who can afford to live within a BART ride's distance of the city. Then there's the steadily rising minimum wage (on July 1, San Francisco's will increase from $12.25 to $13 per hour, and it will keep rising until 2018, when it hits $15). Then there are additional payroll and unemployment taxes, employers' contributions to workers' comp, and expenditures linked to city-mandated health care policies (the cost of complying with the city's Health Care Security Ordinance rose in January, while California's health insurance premiums will increase an average of 4 percent this year).

And all that's just the labor side of the equation. There's also the litany of expenses brought on by the city's boom economy, from grotesquely swollen commercial rents (restaurant rents have increased an average of 40 percent since 2010, according to Cushman & Wakefield, a global commercial real estate services company) to in-demand subcontractors who can essentially name their price. There's the rising cost of ingredients like beef and eggs, the former of which increased 87.5 percent between 2010 and 2015. And then there's the competition—for restaurant-ready spaces, for qualified staff, for designers, artisans, and tradesmen, for building inspectors, and last of all, for customers. Oh, and don't forget the rapidly proliferating tech company cafeterias, which poach both restaurant staff and potential diners. For increasingly beleaguered restaurant owners, says Gwyneth Borden, executive director of the Golden Gate Restaurant Association, "it really is the perfect storm."

But it's also a paradox: in some ways, the Bay Area's restaurants have never been more celebrated or in demand than they are in 2016. San Francisco is "the best food city in the country right now" according to *Bon Appétit* magazine, which last August dubbed the Mission's wee AL's Place the nation's best new restaurant. Throughout the Bay Area, we have five Michelin-three-star restaurants, just one fewer than New York. We have menus crammed with the best ingredients in the country. We have a growing population of young, affluent consumers who view eating out as both cultural imperative and competitive sport. And we have a bumper crop of commercial developers eager to anchor their shiny new luxury complexes with equally shiny new destination restaurants. "We get calls regularly from developers who want to pay you to build out restaurants," says Huffman. "I've heard of ten different projects in San Francisco looking to bring somebody in and finance most if not all of the build-out. But even then, it scares the shit out of me."

All that fear is justified when you take a closer look at the growing population of restaurants competing for finite resources. Four years after Trulia found that San Francisco has the nation's highest number of restaurants per capita of any metropolitan area (39.3 per 10,000 households, versus 25.3 for New York City), First Data, a payment technology company, published a study reporting that the city's restaurant sales grew 6.6 in 2015, compared with 3.5 percent for New York. Per the city's Department of Public Health, San Francisco County currently has some 7,500 "food facilities," a number that reflects "tremendous growth in recent years," says department spokeswoman Nancy Sarieh. The explosion in the restaurant sector has been in part influenced by mainstream-media coverage of the city's economic boom. "From the national press standpoint, San Francisco looks like the gold rush again. People want to get in," says Dennis Leary, owner of the Sentinel, the Golden West, and a small constellation of downtown bars. "But I don't think they've done the due diligence for how expensive it is to operate in a city like this." Leary recalls a recent conversation he had while looking at a space in SoMa. "The leasing agent said, 'San Francisco is finally on the map now; we're getting a lot of investment inquiries from restaurant operators in D.C. and Chicago.'" In other words, incumbent restaurateurs aren't just competing against each other anymore—now they're getting outbid and undersold by Eastern transplants (a dynamic that should sound awfully familiar to anyone who's tried to buy or rent a house here lately).

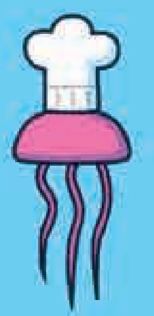
And so the restaurant industry has arrived at a peculiar juncture. Yes, there are boundless riches being thrown at new dining concepts. And yes, new restaurants keep opening—in numbers that are "the highest we've seen in ten, twenty years," says Doug Washington, a partner in San Francisco's Stock & Bones restaurant group. But there's also the sense that we're due for if not an outright restaurant rapture, then what Robert Wright, general manager of Octavia and Frances, terms "a culling of the herd." The numbers aren't adding up, particularly for traditional, service-intensive, midpriced restaurants. "Absolutely, people are worried," the GGRA's Borden says. "Everyone is looking around, wondering who it's going to be. There is going to be a correction in the market at some point. It's just not sustainable at this level."

Has San Francisco reached Peak Restaurant? Leary laughs at the question. "I think we're a little past it," he says. "Peak Restaurant was last year."

WHEN YOU ASK OWNERS TO name their businesses' most vexing challenges, the answer is consistent: labor and wages. The former has been a chronic issue for the past couple of years, with labor shortages driven by unprecedented levels of competition for staff, not only among restaurants but also with tech company cafeterias that can offer chefs decent salaries (reportedly in the high five to low six figures), humane hours, and 401(k) plans. This is most pronounced in highly skilled workers like sous chefs: "Twitter's just taking them all," says Anna Weinberg, the owner and managing partner of Big Night Restaurant Group, which includes Marlowe, Park Tavern, the Cavalier, and the recently opened Leo's Oyster Bar. "I've had three

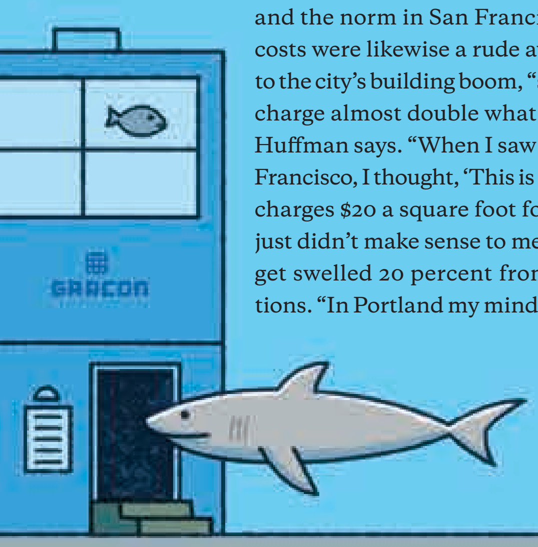
hostesses stolen; they're being paid $85,000 a year to be receptionists at tech companies that shall go unnamed. And by the way, I can't tell them not to do it—the lifestyle is so much better."

As such, "everyone's had to adjust their metric for what they'll accept for talent in the kitchen," says Octavia's Robert Wright. Some restaurant owners compensate for lack of front-of-house staff by spending more time on the floor. Others account for less-experienced cooks by tweaking their recipes to make them heavier on prep and lighter on execution. What's more difficult is offering enough perks to inspire loyalty among employees in a buyer's market. "When new restaurants open they have the advantage of writing a business plan where the dishwasher makes 15 bucks an hour," says Wise Sons Jewish Delicatessen co-owner Evan Bloom. "So my dishwasher is like, 'I can go work somewhere else for $15.' And I can't just ratchet up my prices. So you're forced to decide willy-nilly: Well, I've got to give people raises, and I don't think it'll work with my cost model, but I've got to stay open. So we try to find other places to cut." One tactic Bloom has used is to give a raise that carries more responsibilities: "I'll say, 'You're not just the dishwasher now. You're a prep cook too.'"



In a certain respect, restaurants are faced with the same problem afflicting tech start-ups, which struggle with high turnover rates among an itinerant millennial workforce eager to take advantage of the boom. "I feel like the expectations from an employee coming in are much different, and we've had to change the way we look at people," says Marla Bakery co-owner Joe Wolf. "For better or worse, you don't expect them to stay for very long, so how you train and create positions has to be more general."

The competition in turn compounds the effects of the impending minimum-wage hikes: "It's not that paying the dishwasher $19 is going to bankrupt you," says Andrew Hoffman, co-owner of Comal and the Advocate in Berkeley, whose city council last year considered raising the minimum wage to $19 and hour. "It's if you pay him $19, what are you going to pay the sous chef? That's the part that people forget about." Tellingly, every restaurant owner interviewed for this story stressed that he or she is in favor of a higher minimum wage—as Stock & Bones' Doug Washington says, "You can't tell me there's anyone who works harder than a restaurant cook." But almost all of them emphasized that the common perception that restaurants are "making money hand over fist," as Nopa co-owner Laurence Jossel puts it, is completely and utterly false. "That's the thing with the restaurant business—even if you're super successful, you're only bringing six cents on the dollar to the bottom line," says Joe Hargrave, co-owner of Tacolicious (and husband of *San Francisco* contributing editor Sara Deseran).



Hargrave, who declares he's "as liberal as they come," can expound at length upon his industry's current economic woes. "What happens is legislation gets passed because of people like my mother who are reading the *Chronicle* and want to raise the minimum wage. What they don't understand with our industry is that 70 percent of front-of-house—meaning servers'—wages are made off of tips." Thanks to California Labor Code Section 351's prohibition on a tip credit (counting tips toward the minimum wage obligation), higher wages plus wafer-thin margins means that "cooks making $13 to $14 are stuck because waiters making $200 in tips went from $10 to $12.25," Hargrave says.

Added to the ongoing minimum-wage hikes are higher health care costs: This year, the city raised the amount that employers must contribute to the Health Care Security Ordinance (a program for uninsured residents). Businesses with more than 100 employees went from $2.48 to $2.53 per hour per worker, and those with between 20 and 99 went from $1.65 to $1.68. Under the city's health care spending law, employers can alternatively contribute to standalone Health Reimbursement Arrangements (HRA). But thanks to last year's passage of legislation sponsored by Supervisor David Campos, which closed the so-called loophole in the city's health care law that allowed some employers to pocket health care contributions meant for their employees, businesses can no longer recoup unused funds in those HRA accounts. Under the new legislation, the recoverable costs will shrink from 20 percent this year to zero in 2017—meaning that restaurateurs will never again see the sometimes considerable amounts of health care dollars their (presumably healthy) employees have left on the table. "So here's the problem," says Hargrave. "I'm paying $850,000 a year to insure Tacolicious employees. I promise you that $100,000 of that money will not be used. My average employee is 26 years old and drinks enough on a nightly basis to kill any bacteria in their system." Of the Campos legislation, he adds, "The city went on a witch hunt, basically because the government wanted money."

While Hargrave may be biased, to say the very least, the situation illustrates just how much the restaurant industry has evolved since the days when servers cheerfully reported zero income to the IRS and HR compliance was something reserved for middle managers in distant office parks: "You're suddenly running a sophisticated business, which it didn't used to be," says Big Night's Anna Weinberg, whose empire has grown from one restaurant to four in the past four years. "The conversation has changed so much. It's just no bloody fun anymore; now we're just like everybody else."

THE UPSHOT OF ALL OF THIS, of course, is that restaurant owners are scrambling to compensate for higher costs by trimming as much fat as they can. For some that means hiring fewer employees and loading them with more responsibilities—as well as striving to avoid employee turnover, which is costly. Some are skimping on previously gratis items—"I don't give pickles to everybody anymore," Leary says—while others, like Rose Pistola owner Laurie Thomas, are slashing valet service. "So maybe I lose customers that drive up from the Peninsula because I don't want to write a check for $4,000 each month," she says. "But there are only a few levers that you have."

Some restaurants have turned to the tipless model as a cost-saving measure. In Berkeley, the owners of Comal and the Advocate started making the switch a couple of years ago, when they saw the shape of things to come. "Our service-charge-slash-revenue-sharing system gives us an advantage and protects us against the increase in minimum wage," says Hoffman. And while several Bay Area restaurants have made similar forays in the past year only to revert to a tipped system after being crippled by higher taxes and defecting servers, Hoffman insists that a 20 percent service charge has been a success for his businesses. "Our staff is way into it," he says. "It's nice to be able to hire people and show them what they can expect their income to look like." Still, he says, it's come at a greater expense: "We're less profitable, period."

The silver lining to this enforced scrimping and pinching is that it's arguably forced many restaurant owners to be better, more efficient operators, who are as invested in streamlining their businesses as they are in making their staff happy. "A big focus of mine is trying to make employees feel valued," says Thomas; as part of her efforts, she closed Rose Pistola during the Super Bowl to throw a staff party complete with gift bags. "We had so much turnover last year. So you cut costs and then focus on trying like hell to keep getting better and better reviews, because that means more business, which means servers make more money."

The downside? "There's only so much you can cut before you raise prices," says Jossel. "There's no hidden thing, like, oh, we shouldn't get garbage picked up anymore. You have to raise prices." And depending on the kind of restaurant you have, that can be a particularly thorny subject. In February 2015, when Corey Lee instituted a service charge at Benu and raised the price of his tasting menu from $195 to $228 (it's now $248), no one batted an eye—his customers can clearly afford it. But if your entire concept is built around accessibility, raising prices can raise diner ire. The average restaurant customer has little to no idea what costs are built into the price of their $13 hamburger, but does know when he or she feels ripped off.

"People are like, 'Aren't you precious, selling $5 croissants.' Well, no, we're just trying to pay our bills," says Marla Bakery's Wolf. "But try to explain to someone the idea that organic butter is five times the cost of conventional butter. They don't give a shit. They just see it as being four times as expensive [as another croissant]. People have their limits they're not going to go above, and they don't understand why they would need to."

And that's why higher menu prices don't necessarily mean proportionally higher check averages: "When restaurants raise prices," says Borden, "people order less." And if customers aren't ready for higher prices, well, that's too bad. "[They're] going to have to stop asking us to subsidize their lifestyle," Weinberg says flatly. "You're going to have to pay double for your steak if you want to live in this fabulous city. I can't absorb it anymore."

ADRIANO PAGANINI, the founder of Super Duper Burger and one of San Francisco's most prolific restaurateurs, sums up the current situation this way: "Anyone who opens a restaurant needs to create a concept that is really 'on' in some way and isn't marginal. Because marginal isn't working anymore."

Charles Bililies is one of those owners who's managed to locate the "on" button. In 2014, when he decided to channel his years of experience working for Thomas Keller and Michael Mina into his own restaurant, his "basic impetus," he recalls, was to combine fine-dining, full-service standards—good wine, candles on the table—with the efficiency and margins of a fast-casual establishment. The result was Souvla, a Hayes Valley Greek sandwich shop that opened to almost instant success. On a typical day, it serves 600 people with an average check total of $19 at lunch and $21 at dinner.

Souvla's business model, which Bililies calls "fine casual," offers him a number of advantages: Because customers order their food at a counter, it can operate with far fewer employees than a traditional full-service restaurant—there are only three to four in the dining room, and the kitchen is likewise small. On the flip side, Souvla does tremendous volume through catering and delivery, in addition to on-site sales. "I'm a firm believer that the ability to do volume consistently and successfully really solves a lot of these issues," says Bililies, who is planning to open a second Souvla on Divisadero this summer. "I truly think it is one of the only ways to succeed in a high-cost environment like San Francisco."

Plenty of restaurateurs share his opinion that fast- or fine-casual is the way of the future. When Mercer Restaurant Group owner Matt Semmelhack and his partners began planning Sababa, the Israeli pita bar they're opening in the Financial District this spring, they decided to include a catering area dedicated to receiving orders from various delivery apps. "If we have a team of cooks prepping an order for 100, they can serve them with less labor hours than three employees at the register can serve 100 people," says Semmelhack, whose portfolio includes AQ and Bon Marché. "It's not glamorous, but it's an adjustment. If you're a restaurateur today and not using the hundreds of apps available to you, then, for many reasons, you're behind."

A similar mentality informed the genesis of Wise Sons Bagel & Bakery, the recently launched spin-off of the Jew-veau delicatessen in the Mission. Although Bloom and his business partner, Leo Beckerman, love a good bagel, they also see the low-cost baked good as a way to offset the rising price of the meat they use for their pastrami. "Selling flour and water is cheaper," Bloom says. Although they currently have just one bagel shop, on Fillmore Street, the plan is to open two or three bagel kiosks throughout the city—each one just a counter staffed by a minimum of employees, busily maximizing the bottom line.

If this lust for volume and efficiency strikes you as less than romantic, well, we've reached a point, according to Paganini, where "you need to make damn sure that you're going to be very busy at all times. Otherwise, don't even do it." As such, says Ryan Cole, one of the owners of Hi Neighbor Hospitality Group, "the biggest challenge is getting restaurant owners to think on behalf of the guest and not that they're making an art statement." Cole had one of 2015's most unequivocal successes with Trestle, a Jackson Square restaurant built around the conceit of a $35 three-course prix fixe menu; later this year he'll go the fine-casual route with Corridor, a counter-service restaurant where customers will order high-quality food made with nonpedigree ingredients. "It's about being creative," Cole says. "You figure out how to use ingredients that don't cost as much but taste good. The advantage restaurants have right now is that people are willing to try anything."

To be sure, restaurant owners are looking for solutions beyond fast-casual: Some, like Weinberg did with Leo's Oyster Bar, are opening small restaurants with fewer staffing requirements. Some, like Jossel, dream of subsidized housing for cooks, though so far that fantasy has been limited to conversations he's had with fellow restaurateurs. Some are turning failed restaurant spaces into homes for pop-ups, as the owners of Ichi Sushi did after closing Ichi Kakiya. Some, like the Pearl's Huffman, are tying their restaurants to large event spaces that will be their primary income drivers. And pretty much everyone dreams that the state will adopt a tip credit, though no one really expects it, in part because of the preferences of organized labor, which opposes tip credit everywhere and exerts huge influence over the California legislature. So "unless there's a complete Republican takeover of the legislature," Borden quips, "tip credit is not coming back to California."

But however our predicament evolves—and particularly if the tech economy falters—one thing that seems likely is that, similar to its middle class, San Francisco's full-service midpriced restaurants are soon to become an endangered species. The list of the already fallen—Local Mission Eatery, Rickybobby, the Abbot's Cellar, Betelnut, Urchin Bistrot, Chino (which, while not a "top-line failure," according to owner Hargrave, couldn't make its labor and food costs work)—will welcome many new members to its ranks.

FACED WITH SUCH uncertainty, some restaurateurs take comfort in the long view: Between the first dot-com bust and the Great Recession, plenty of operators have weathered their share of upheaval. "I've been in this long enough to know there's been five CONTINUED ON PAGE 00 ➡

BUILDING A BUSTPROOF RESTAURANT FOR THE FUTURE

The full-service, midprice, low-volume restaurant business model isn't working anymore. But here are five concepts that have a (better than average) fighting chance.

CHIPOTLE + TABLECLOTHS: There's counter service, yes, but also decent wine and candles on the tables. In short: You can take a date here. See: Souvla, Little Gem

THE 1-PERCENT WONDER: So Saison raised its tasting menu price by $150? Pfft. That's what I found in my couch cushions yesterday. See: Benu, Quince

MCDONALD'S WITH FEELINGS: Your burger gets assembled in front of you and slapped onto a tray, but hey, the patty is grass-fed. See: Super Duper Burger, Asian Box

SWEET DELIVERANCE: Volume, baby, volume. Thanks to delivery apps like UberEats, transcending a restaurant's (hopelessly 20th-century) four walls has never been easier—or, frankly, more necessary. See: the upcoming Sababa, Souvla

THE BESPOKE HOLE-IN-THE-WALL: Small is beautiful. It means a small staff, and thus, smaller labor costs. It also means that it takes fewer customers to make the place look like it's thumping. Lines: also beautiful. See: Leo's Oyster Bar, AL's Place

The Great Restaurant Deluge

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to ten times where everything changed and everyone said, 'The sky is falling,'" says Washington. "Like when Obamacare came in, when rents went up, people said, 'We're done.' And yet more restaurants opened this year than anytime I can remember. If it's so impossible, then why are people investing in and opening restaurants?"

Of course, restaurants have always been considered awful investments—so high-risk they can barely qualify for decent bank loans. Perhaps that's why so much of the money being poured into them comes from people enmeshed in a sector that's all but synonymous with risk: the tech industry. According to Stewart Alsop, a venture capitalist whose restaurant investments include Park Tavern, Lazy Bear, and Brandon Jew's soon-to-open Mister Jiu's, "Restaurants are almost entirely financed by people who are doing it for personal reasons." No investor gets into the restaurant game, in other words, with an expectation of great riches. Some do it to be guaranteed a hot reservation, others to be part of the community. Mike Harden—a professional investor who has an ownership stake in 11 restaurants, including Tacolicious, Marlowe, and Spruce—notes that while San Francisco has a fairly large group of restaurant investors, most of the approximately 50 projects he considers every year are from established, successful operators. "My point is that the restaurant industry has done well in terms of proliferation, but as costs rise the risks go higher and higher and you see fewer people taking that risk," he says. "It really crowds out the smaller operators."

And arguably, that's who really stands to lose in this current climate: smaller, independent, first-time restaurant owners who lack the track record to attract big VC bucks—not to mention the cash flow to pay the rent while they survive the interminable wait for the city's gauntlet of inspectors to approve their space. That is, if they have enough money to compete for space in the first place. Given the circumstances, it's amazing that anyone tries.

And yet, they do try. This spring, Kim Alter, a celebrated chef who worked for Daniel Patterson at Oakland's Haven and Plum, is planning to open her first restaurant, Nightbird, in Hayes Valley. It's not fast-casual. It's not super-high-end. It's not connected to a catering operation. Instead, it's a 38-seat restaurant serving a tasting menu that changes nightly. And, Alter says, "It's terrifying. Every day I wake up in a panic." When she's not worried about paying her unborn restaurant's $10,000-plus monthly rent (which she calls "fair" for the neighborhood), she's worried about raising more money. "So many other talented chefs are going to the same people for the same money with slightly different concepts," she says. Though Alter has 20 years of experience as a chef, this is a different beast entirely.

"The fact that I'm opening a tasting-menu-style restaurant with no tipping scares the hell out of me," Alter says. "Not because I don't think we'll be amazing, but will I be able to fill my restaurant every night, or will someone bill me as a special-occasion place? Am I effing up right now? Should I just open a burger-and-pizza joint and have roast chicken on the menu?" She's also worried about competition, but not of the traditional kind: "It's apps like Munchery and Postmates," she says. "The convenience of being able to get what you want without going out is more scary than another brick-and-mortar opening up."

And so, given the odds, the terrors, the rents, the competition, the bureaucracy, and the pressure to succeed the minute you open your doors in this beautiful, impossible, oversaturated city, why even bother? "Because," says Alter, speaking perhaps for everyone who's ever dared to wade into the shark-infested waters of the best dining city in America, "I want to experience owning my own restaurant in San Francisco. For me, the struggle's worth it." ■